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Reflecting on Recommendation 6 of the IGTO: Review into Death and Taxes

October 2020

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Published by BNR Partners Pty Ltd ABN 85 354 278 697

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Reflecting on Recommendation 6

Introduction

1. The Inspector-General of Taxation and Taxation Ombudsman (IGTO) recently released a report entitled *Death and Taxes: An Investigation into Australian Taxation Office Systems and Processes for dealing with Deceased Estates.* The report makes a number of recommendations that are intended to reduce the tax compliance and other cost burdens associated with the administration of an estate of a deceased individual.

2. The Report noted that there were broader taxation policy issues at play which fell outside the IGTO's tax administration functions. However, the IGTO observed that these policy issues should be carefully considered and, where possible, a solution designed to minimise or reduce the complexity and compliance costs for people seeking to finalise the estate of their loved ones[1].

3. To this end, Recommendation 6[2] provided that the ATO:
   - explore with external stakeholders, such as members of the National Tax Liaison Group, or other consultation forums, the consequences and challenges associated with applying general taxation of trusts principles to deceased estates; and
   - where appropriate, make submission for further inquiry to bodies such as the Board of Taxation or lodging minutes with the Treasury noting the potential for law change.

4. While acknowledging that, in the current circumstances, law change in this area may not be high on the government's list of priorities, this paper seeks to examine issues that arise in the context of the current legislative provisions and considers what an alternative regime for taxation of deceased estates might look like.

5. The paper considers how the current administrative an policy issues might be alleviated by treating the deceased and their estate as one tax entity (separate from any trust that might arise from the estate).

Background

6. For tax purposes, a deceased person and their estate are treated as separate tax entities. This immediately adds administrative complexity because each entity will require separate TFNs and income tax returns.

7. An 'upside' for taxpayers is that they get two tax free thresholds in the year of death, but the 'downside' is that losses (and certain other tax attributes) do not pass across from the individual to their estate. [3]

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[1] Page 72

[2] Page 38

[3] This itself can be confusing as there are other provisions which have the effect of allowing those attributes to pass across (such as section 70-105 of the ITAA 1997 for trading stock).

8. Failure to obtain an estate TFN in a timely fashion can draw the estate into the TFN withholding rules[4] and in some cases mean that an estate tax return must be lodged merely to recover tax withheld.

9. While one might think that obtaining a TFN should be a relatively straightforward/low cost activity, that is not necessarily the case particularly if the the legal personal representative (LPR) is a foreign resident.[5]

10. A foreign LPR must pass the same identification process as if he/she were applying for a personal TFN. The LPR must:
    - provide at least two proof of identity documents of which one must be primary.
    - the documents must be certified by a notary public or staff at the nearest Australian embassy.

11. Australian consulates and embassies aren't widely available and are not necessarily easy to get to in a pandemic. Imagine the dismay of an elderly LPR who resided outside of a town centre and made a special trip for certification only to find that they had brought the wrong document and had to undertake the journey a second time. Further as the ATO will accept only original paper copies of the certified documents there can be significant delays in the documentation being received in Australia and then being processed by the ATO.

12. However, the biggest driver in terms of complexity is the fact that a deceased estate is taxed as a trust (even though it isn't at general law).

13. The trust assessing provisions are notoriously difficult and the preparation of trust tax returns would generally require the services of a tax agent (even where the return is only being lodged to obtain a franking credit refund or a refund of tax withheld). In many instances, the cost of the return will be more than the amount of the refund.

14. Even determining the rate of tax that an LPR might pay is not a straightforward question. For example, although there is a concessional rate for deceased estates; that rate applies at the Commissioner's discretion.[6] And there is a difference in the rate depending on the number of years since the death of the individual.[7]

15. Not only do the trust assessing provisions apply, but estates can be drawn into other complex trust rules like the closely-held trust TFN rules and all that those rules entail.[8] [For example, an LPR who fails to withhold where a TFN has not been quoted by a beneficiary could be subject to a penalty equal to the amount of tax that should have been withheld.]

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[4] These rules require an mount to be withheld from payment of certain income by where a TFN has not been quoted – see Subdivision 12-E of the *Tax Administration Act* 1953.

[5] ATO website QC20108

[6] While the Tax law Improvement Project sought to replace discretions with tests of reasonableness, the trust provisions have never been rewritten into the ITAA 1997.

[7] As explained in TD 1992/192

[8] sub-paragraph 12-175 (1) (c) (i) in Schedule 1 to the TAA and section 272-100 in Schedule 1 to the ITAA 1936. These rules apply if the estate is unadministered for more than five years

16. The broad approach to tax for a deceased estate is that LPR will be assessed (at concessional rates compared to other trustees, especially for the 3 years after death) until the administration in respect of the various assets of the estate has been completed. Thus, for example, if the LPR assents to the distribution of an asset to a particular beneficiary, that asset is technically held on a bare trust for distribution and subsequent income from that asset will be assessed to the beneficiary entitled to the asset; while the income from the residue may continue to be assessed to the LPR of the estate.

17. Testamentary trusts may also arise at the end of administration. Notwithstanding the separateness for legal purposes of the estate, bare trusts and testamentary trusts arising after administration, in practice this is not well understood by the tax community and different approaches are likely to be taken in practice.[9]

18. Further complexity arises from the fact that the tax position of the estate of an Australian deceased individual may well depend on the residency of their LPR even though all of the deceased's assets are held in Australia and all beneficiaries are Australian resident for taxation purposes.[10]

19. As the IGTO observed in this regard:

> *it is unlikely that deceased persons will turn their minds to the residency of their deceased estate when nominating their executor. It may also be the case that at the time of establishing their will, they could not foresee a situation where their nominated executor would become a non-resident for Australian tax purposes. The lack of control in such a situation places both the executor and the estate's beneficiaries in a difficult situation and having to navigate not only laws on taxation of trusts, but additional rules specific to non-residents.* [11]

20. And in the converse, the estate of a 'foreign' deceased person will be an Australian resident trust if the only connection it has with Australia is an Australian resident LPR (including if others are resident overseas). This means that to the extent that the beneficiaries are not assessable, the LPR will be assessable on the worldwide income of the estate (subject to the operation of any double tax agreement).

The current system: more detail

21. The complexity is brought into sharp focus in the context of determining how capital gains from the sale of assets that the deceased owned are to be taxed.

22. The general policy of the CGT deceased estate rules is that the recognition of a gain or loss from an asset owned by a resident deceased person is deferred until the asset is sold by their LPR or a beneficiary in their estate. This is achieved by transferring the deceased's cost base and reduced cost base for the asset to their LPR/and later to a

[9] Even ATO practices are at times inconsistent – although paragraph 5 IT 2622 suggests an estate and testamentary trust would be treated as one entity, we are aware of the ATO ringing practitioners advising that the trust should apply for a separate TFN (so that the trustee does not incorrectly obtain a medicare levy exemption).

[10] If the trustee (or all trustees) of a trust is (are) foreign resident(s), the trust estate will not be a resident trust estate. This can affect the amount that is taxed in Australia.

[11] page 72 of Report

beneficiary.[12]

23. However, gains and losses that would otherwise avoid taxation in Australia are intended to be brought to tax. Thus, CGT event K3 happens when an asset passes to certain tax advantaged entities; including when non-taxable Australian property[13] passes to a foreign resident[14]. [The event is taken to happen just before death and so captures gains only up to the time of death in the deceased's final income tax return.[15]]

24. If a resident LPR sells an asset that the deceased owned before death, then any gain or loss is taken into account in working out the net income of the estate. The rules for determining who is assessed on a net capital gain are quite complex. An LPR can choose to be specifically entitled to a capital gain (if trust property representing the gain has not been paid or applied to a beneficiary within two months of the end of the relevant year of income) with the result that the LPR will be assessed at the rates applicable under section 99 of the ITAA 1936[16] (this includes the benefit of the CGT discount).

25. If a beneficiary is made specifically entitled to a trust capital gain then they will be assessed on it; or if the beneficiary is a non-resident at the end of the income year the trustee will be assessed on their behalf under section 115-220 of the ITAA 1997/section 98 of the ITAA 1936.

26. If there are capital gains to which neither the trustee or beneficiaries are specifically entitled, the trustee will be assessed if there is no trust income or income to which no beneficiary is presently entitled. Otherwise the beneficiaries (or the trustee on their behalf) will be assessed.

27. This result is largely consistent with the intended policy, although there are some irregularities. For example, if a non-resident beneficiary is made specifically entitled to a capital gain a from a non-TAP asset, section 855-40 of the ITAA 1997 may apply to disregard it (depending on whether the stage of administration has been reached

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[12] Division 128 of the ITAA 1997

[13] 'Taxable Australian Property' is defined in section 855-15 of the ITAA 1997. Primarily it consists of land in Australia and interests in land rich entities.

[14] There is a separate question whether an asset 'passes' to a beneficiary prior to it being transferred to them. The ATO suggests that an asset can pass to a beneficiary if the beneficiary becomes absolutely entitled to the asset – which could perhaps happen if an executor makes an assent in favour of the beneficiary. However, given that the ATO takes the view that only a single beneficiary can be absolutely entitled to a trust asset, an estate asset would not pass if the executor had made an assent in respect of joint beneficiaries.

[15] An issue arises when the estate administration process exceeds past the period available to amend the deceased person's assessment for their final return. As it currently stands, if CGT event K3 happens after the amendment period of 2 or 4 years has expired, then it is essentially a tax-free gain because an amendment of a prior year assessment is statute barred. However, the general anti avoidance provisions Part IVA of the ITAA 1936 may need to be considered if this eventuality is planned.

This problem is known to regulators and was proposed to be addressed by amendment.[15] The proposed amendment was designed to capture any gain or loss from this CGT event in either the estate or testamentary trust tax return at the date of transfer, albeit at market value at the date of death of the testator. The subsequent Federal Government announced on 15 December 2013, as part of its 'Announced but unenacted measures' review, that it was not proceeding with the measure. The same issue will arise when assets are held within a testamentary trust for the benefit of a life tenant, and on their death, transferred to a tax advantaged entity such as a non-resident beneficiary.

[16] section 115-222 of the ITAA 1997

where the estate might be regarded as a fixed trust). This is inconsistent with the notion that gains that accrued to the deceased should be brought to account here (ie under CGT event K3).

28. However, the existing regime appears to assume that the LPR of a deceased person who was a resident of Australia will also be resident here. When the provisions were drafted having a foreign resident LPR was probably uncommon. But with high levels of migration to and from Australia (at least pre-pandemic), it is likely to be more commonly encountered.

29. As illustrated in the examples below, inappropriate policy outcomes arise where the LPR is a tax resident of a country that is different from the deceased.

Resident deceased – foreign LPR

30. Where the LPR of a deceased estate is a foreign resident, the estate will not be an Australian resident trust for taxation purposes. This means that capital gains and losses from non-TAP assets are not taken into account in working out the 'net income' of the estate.

31. This is because section 855-10 of the ITAA 1997 which requires the trustee of a foreign trust to disregard gains and losses from non-TAP assets overrides the requirement in subsection 95(1) of the ITAA 1936 that the trust net income be calculated on the basis that the trustee was a resident taxpayer.[17]

32. However, when untaxed amounts are paid to a resident beneficiary those amounts are potentially assessable under section 99B of the ITAA 1936. [Section 99B does not apply if the beneficiary is a non-resident for the entire income year in which the distribution is paid].

33. The ATO takes the view in Taxation Determination TD 2017/24, that an amount attributable to the non-TAP gain of a non-resident trust will be assessable under section 99B of the ITAA 1936 when distributed to a resident beneficiary. Further, the TD takes the view that the amount made assessable by subsection 99B(1) does not have the character of a capital gain for Australian tax purposes, nor is there any linkage between subsection 99B(1) and Subdivision 115-C of the ITAA 1997. This means that an amount which is included in assessable income under section 99B cannot be reduced by a capital loss or the CGT discount.

34. There are exceptions to the application of section 99B[18]. Perhaps the most important exception is for distributions of trust corpus. However, that exception does not apply to so much of a corpus distribution that would have been assessable had it been derived by a resident taxpayer. Accordingly, TD 2017/24 takes the view that a distribution from corpus that is attributable to a capital gain does not fall within the corpus exception.

Example – resident deceased; foreign LPR

Bob Builder resided in Sydney throughout his life. When he died in 2019, he had an extensive portfolio of ASX listed and foreign company shares.

[17] The consequences are discussed later.

[18] see subsection 99B(2) of the ITAA 1936

Bob was survived by his three children, Boris, Doris and Wendy. Doris and Wendy live in Sydney. However, Boris lives in the UK, having migrated there in 2014.

Bob's Will, which he executed in 2010, appointed Boris as his LPR.

Boris, as LPR, sold Bob's shares and made capital gains totalling $6m.

As Boris is a non-resident, the $6m is excluded from the net income of the estate and is therefore not taxed in the year it is made.

Two years later, Boris distributes $2m attributable to the gains to each of Doris, Wendy and himself. Boris is not assessable in Australia. Doris and Wendy however are each assessed on $2m. They are not entitled to any CGT discount even though Bob/Boris owned the shares for at least 12 months.

- If Doris had been the LPR, the gains would have been included in the estate net income. Depending on the particular circumstances, Doris as LPR may have been assessed under section 99 of the ITAA 1936 on $3m ($6m capital gains reduced by the 50% CGT discount). [This may be because Doris chose to be specifically entitled to the capital gains under section 115-230 of the ITAA 1997 or because there were no beneficiaries presently entitled to income of the estate.]

- Alternatively, if the beneficiaries were assessed in respect of their share of the capital gains (because they were made specifically entitled to them), Doris and Wendy would be entitled to the CGT discount. [Boris may be exempt under section 855-40 if the estate administration had reached the stage where the trust could be regarded as a fixed trust.]

Foreign resident deceased – resident LPR

35. Other issues arise where a foreign deceased individual has a resident LPR. That is, as their estate is a resident trust estate all foreign income might[19] be assessed here even though the deceased individual's only connection with Australia is their choice of LPR.

36. The CGT rules mainly produce an appropriate policy outcome. The LPR is taken to acquire the deceased's non-TAP assets for their market value at the date of the death. This ensures that any gain inherent in the asset at the time of death is not subject to tax here. Further if the LPR sells the asset and makes a capital gain, a foreign resident beneficiary's share may be able to be disregarded under section 855-40 (if the estate administration has reached the point where it is regarded as a fixed trust).

37. However somewhat inconsistently with the general policy of the CGT discount provisions, it appears that a resident LPR is not prevented from claiming the CGT discount in respect of TAP assets that the deceased owned even though the deceased, as a non-resident, would not have qualified for it.[20]

Example – foreign deceased; resident LPR

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[19] Subject to operation of relevant DTA

[20] See private ruling 1051756645843. The Commissioner may refuse to exercise the discretion to apply section 99. If the LPR were assessed under section 99A, section 115-222 of the ITAA 1997 denies the benefit of the CGT discount.

Kerry Kiwi resided in New Zealand. She owned a rental property in Sydney that she acquired in 2015.

Kerry died in June 2018. She appointed, as her LPR, her sister Kylie who resides in Australia.

Kylie, as LPR, sells the property in June 2019 and makes a capital gain.

Kerry would not have been entitled to the CGT discount if she sold the property because of section 115-105 of the ITAA 1997. However, as Kylie is a resident trustee, she is entitled to the CGT discount.

Kylie may wish to confirm that the Commissioner will exercise his discretion to assess the rental income and capital gain under section 99 of the ITAA 1936.

A new approach

38. As suggested by the IGTO, the key to simplification would be to remove deceased estates from the regime that applies to trusts. One approach might be to treat the deceased individual and their estate as one tax entity; that is, as if the deceased had continued to live, though with rules about the collection of tax from living taxpayers such as their LPR.[21]

39. The table below looks at some of the advantages and disadvantages of such an approach:

Advantages	Disadvantages
Single tax file number – cost saving; avoid processing delays; avoid TFN withholding issues – that is, no need to lodge returns where tax withheld. Treatment of the estate as in individual taxpayer rather than a trust – much simpler to prepare returns and there is an existing system in place to obtain franking credit refund. Facilitates ongoing PAYG collection	
Removing demarcation between the deceased and their estate would render unnecessary the numerous rules that deal with this interface – for example, technical disposal and the need for rollovers of gains and losses (including with trading stock and depreciating assets), revenue and expense allocation would not be needed Much simpler and cheaper to administer. In the year of death, the at times significant compliance cost of splitting income and deductions between pre and	Only one tax free threshold in year of death

[21] If the deceased has separate LPRs in different jurisdictions, then the rules would need to specify which LPR was responsible for the payment of tax. See issue in private ruling 1051658665187.

post death periods can be avoided. In many cases, we suspect that taxpayers simply do not comply with this requirement and so the burden of compliance falls on the better advised. Revenue implications: • Losses of the deceased can be used after death • Pre-CGT assets would stay pre-CGT longer until transfers to beneficiary. • Tax free threshold would be available for indefinite period after death – ie no 3 year rule. [BUT, specific rules could be adopted to stop these revenue effects if desired by Government.]	
Avoids complexity where the LPR is resident in a different country- and avoids the section 99B issue for non-resident estates and the complexity of section 102AAM interest calculations if the estate administration extends beyond three years	Non-resident deceased and TAP – lose access to discount – but access to discount appears to be unintended and so the result would be consistent with policy. Ability to split estates – lose ability to split estates between resident and non-resident to obtain an Australian tax advantage. [Would still need rules about who tax is to be recovered from in this scenario]
Avoids complexity of present entitlement rules and disputes between the LPR and beneficiaries about who pays tax. Greater certainty – avoids issues about application of section 99/99A in the context of the estate – Commissioner discretion becomes irrelevant Avoids Div 11A application where LPR/beneficiary are foreign residents and complex interactions with Division 6	Lose the ability to manipulate the present entitlement rules Not clear how the DTAs would apply
Other issues	
CGT event K3 – could happen when asset passes – this deals with the defect in amendment period which prevents gains from being taxed as intended	Gains that are not taxed because of amendment period defect will be taxed – although the result would be consistent with the intended policy.

	Similarly, section 855-40 could not be relied on to exempt non-resident beneficiary's share of gain. Again, this would appear to be consistent with the intended policy.

40. While there are clearly other issues that need to be considered, such as whether a similar arrangement should apply for GST purposes, it seems at first blush that an approach like this would be simpler, more robust and operate more equitably. It might alleviate some of the administrative gridlock that exists under the current system.